

# thebigpicture

guideposts for the private investor

Week Commencing 14 April 2003

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*thebigpicture* guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

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## THE VERY BIG PICTURE

The events in the Middle East might have obscured how long-term trends underlie many of the economic and political developments which affect investment markets.

Many current international political and economic issues can be traced back through the last five decades. In each decade, attitudes and outcomes have tended to be a reaction to what went before. In international politics, for example, there are identifiable linkages between the heyday of world communism and the emergence of the bipolar world order in the 1950s and the fragmented relationships and shifting alliances which currently typify the international political order.

The greatest rewards usually accrue to investors and businessmen who discern these trends and position themselves appropriately. Of course, it is always easier to do this with the benefit of hindsight. Some would also say that tying oneself to a single set of influences or events creates an organizational or investment risk.

That said, what does the decade of the 2000s hold? The honest answer might be "who knows" but there are some tendencies which are already evident.

At a political level, the evolution of global political institutions and relationships continues. As noted in *thebigpicture* last week, the institutions formed in the immediate aftermath of the second world war have persisted despite their usefulness in some instances being reduced.

The idea of natural ideologically based constituencies seems to be a feature of the past. Commercial self interest seems set to rule as a determinant of global alliances.

The bipolar world appears to have given over almost entirely to a far more fragmented set of relationships. Building temporary coalitions successfully now appears necessary for effective implementation of international policy.

The evolution of economic thought was exemplified in the past week by International Monetary Fund comments about deflation. It suggested this might be just as pernicious as inflation had been in the 1980s.

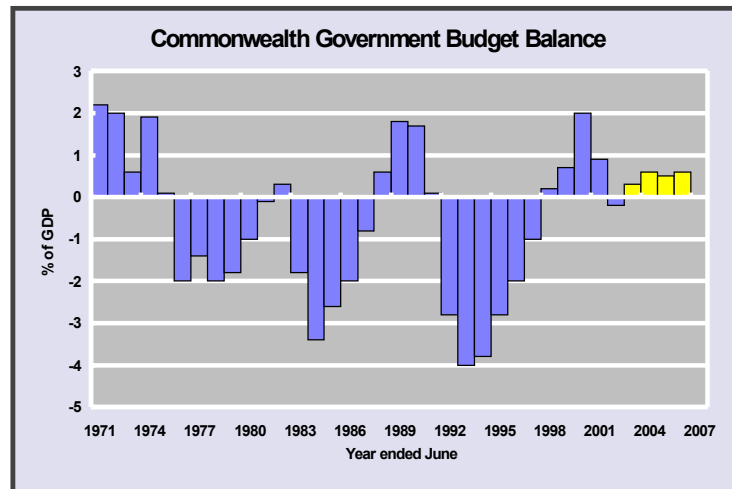
It took two decades for inflation to be purged as a primary problem in the developed

(Continued on page 3)

### The Evolution of International Politics and Economics

1950s	<ul style="list-style-type: none"><li>• Mass production with the emergence of consumerism</li><li>• The heyday of communism and the emergence of the bipolar world</li></ul>
1960s	<ul style="list-style-type: none"><li>• Rapid economic expansion supported by adoption of Keynesian economic policies</li><li>• Decolonisation &amp; the rise of left wing nationalism</li><li>• Emergence of the USA as leader of the developed world</li></ul>
1970s	<ul style="list-style-type: none"><li>• American ambivalence about its global role</li><li>• High inflation &amp; low growth/petrodollar recycling</li></ul>
1980s	<ul style="list-style-type: none"><li>• America takes on the communists</li><li>• America reflates; prevalence of debt financing to take advantage of inflation</li></ul>
1990s	<ul style="list-style-type: none"><li>• The breakdown of the bipolar world</li><li>• Radical shift in business profitability with higher productivity and lower interest rates</li><li>• Recognition of Asia as a market and production centre</li></ul>
2000s	<ul style="list-style-type: none"><li>• America asserts its global role</li><li>• Demographic growth slowdown begins to affect growth</li><li>• Policy moves to compensate for slow growth</li></ul>

## THE WEEKLY CHART SPOT



Source: Australian Department of Treasury

*“This political symbolism which has elevated the budget surplus in the national debate ever since the time of the Whitlam government represents dubious economics and even questionable politics.”*

The past thirty years of Commonwealth fiscal management has been a history of budget deficits punctuated briefly by unsustainable surpluses. The government is likely to work hard to present a budget next month which at least forecasts a surplus.

The chart shows annual cash budget balances since 1970/71 as a proportion of GDP. In 2001/02, the outcome was a deficit of \$1,100 million or 0.2% of GDP, despite a forecast surplus when the budget was presented originally. Despite that deficit, subsequent expenditure commitments and a more slowly growing economy, the government has continued to forecast surpluses for the current and three following years.

The Howard Government has worked hard over the years, first from Opposition and then in government, to establish the virtue of surpluses in the minds of electors. They have been encouraged to equate a surplus with fiscal rectitude, responsibility and competence. The alternative, a budget deficit, is to be seen as a sign of profligacy, higher debt and a loss of control. This political symbolism which has elevated the budget surplus in the national debate ever since the time of the Whitlam government represents dubious economics and even questionable politics.

- In the context of a \$140 billion budget and a \$60 billion bond market, there is no significant difference between a deficit of \$100 million and a surplus of \$100. Nor can the suitability of any budget outcome be judged without regard to the overall national savings requirements.
- The annual debt funding task is also influenced by the quantity of maturing debt needing to be refinanced. This could overshadow the impact of the funding requirement arising from the budget deficit.
- The change in the size of the budget balance is often a more meaningful indicator. A lengthy period of strong growth would normally deliver relatively large budget surpluses. They could be unwound if growth slows and policy needs to be more supportive of growth. Because the surplus has already been unwound, the government has foregone this flexibility through its expenditure decisions and its rhetorical commitment to maintaining a surplus.

It also matters how a particular outcome is achieved. For example, a surplus using tax and expenditure policies which do not accord with sensible microeconomic outcomes might not be worth having. This government has used special levies, asset sales and expenditure reductions which, taken individually and without regard to the quest for a surplus, might have been hard to justify.

The levy on airline ticket sales is just one example. It had been introduced as a specific means of funding the employment entitlements of Ansett employees. It was an initiative directed at a single group to avoid the appearance of government indifference to their plight but it conferred a benefit which was not generally available to other members of the community in similar circumstances. Even then, it is no longer required for its original purpose. And, yet, the government has decided to maintain it for the sake of achieving its budget surplus despite the negative impact it might have on travel and tourism.

## THE VERY BIG PICTURE CONT'D

(Continued from page 1)

economies. Such was the difficulty of the task that a vestigial fear of inflation has persisted among policy-makers through the 1990s and beyond. This fear continues to bias decision-making. Policy implementation is dominated by inflation averse central banks which were accorded independence to ensure that their focus was unimpeded. The implication of the IMF's warning is that the argument for this arrangement might no longer be as compelling as it once was.

Once Iraq is defeated, it might become more obvious that the war is not a primary influence on economic outcomes. A deceleration in economic activity and a reappraisal of equity values was well underway before Iraq loomed so large. So, too, was a population growth slowdown in Europe and Japan, a business and institutional restructuring within Asia and the beginnings of a reorientation of the global population centre toward Asia and Africa.

Policy had already become more supportive in terms of conventional settings. No-

## US Economy: Where To? cont'd

(Continued from page 4)

The problem for consumers is that they are now more reliant on their disposable incomes not only for consumption but also for investment. With equity markets subtracting from wealth and with individuals intent on restoring some of their economic security, a portion of their income has to be saved.

The savings rate has been rebuilt from the end of 2001 (when saving had virtually ceased). Even so, at around 4%, the savings rate is well below the near 10% rates which prevailed at the beginning of the 1990s in the middle stages of the equity bull market.

Income growth is, therefore, translating into less consumption spending that it did during the latter 1990s. Nonetheless, the trend in personal income growth registers a green flag.

Business sales were 1.2% higher in January and 4.5% higher than they had been a year earlier. The sales contraction which had been very evident late in 2001 and through the earlier months of 2002 seems to have passed.

tably, interest rates in Japan had been set at practically zero with little effect. Fiscal and monetary policy had also become more aggressively pro-growth in the USA.

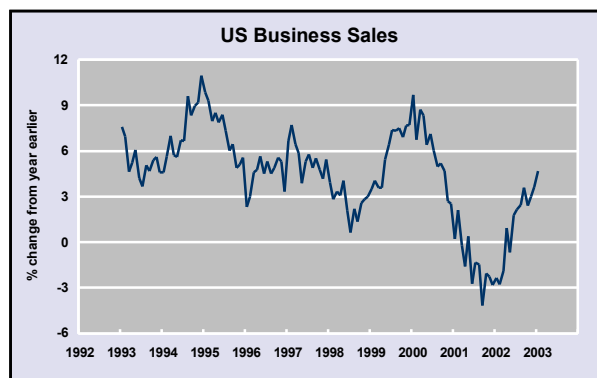
If the primary influences in the 1990s might have implied stronger growth, the 2000s could be seen as the decade when demographic influences begin to constrain activity in the developed economies.

In response, policy settings could become more aggressive as a deflation fear takes hold. The impact might not be speedy, just as ridding the world of inflation as the primary policy concern took time. Nor, given the pressures, is it likely to be fine tuned. Higher liquidity flows, rising inflation and another major interest rate cycle might well ensue as policy tries to resist the pressures.

Who knows! Whatever the eventual course, the more important message is that these primary forces are always working. The biggest risk might be to assume that, with Saddam Hussein and his cronies dispatched, the world will return to normal. Normal just does not exist.

*"The biggest risk might be to assume that, with Saddam Hussein and his cronies dispatched, the world will return to normal. Normal just does not exist."*

That said, new orders for manufactured durable goods decreased by 1.2% in February after a 1.9% rise in January. Again, this stumble might have had something to do with the onset of war in the Middle East. Nonetheless, the business sales indicator provides a green flag.



So, overall, what is the verdict? One red flag and three greens but some of the outcomes are not particularly robust. Nonetheless, the balance is tilted towards the positive implying an economy past its worst and gradually building up some momentum.

## US ECONOMY: WHERE TO?

The US economy has been flashing mixed signals. More positive outcomes will be critical to how US equity markets perform and how much confidence can be relayed to international markets.

The key US economic indicators imply more green flags than red flags at the moment. The National Bureau of Economic Research (NBER) which defines whether the US economy is heading into recession or expanding focuses on four principal areas of activity as guides to the position of the economy in the economic cycle.

The first indicator is employment. Non-farm payroll numbers declined by 0.1% in March. This was the fifth month of decline since August 2002. Over the year to March, employment was

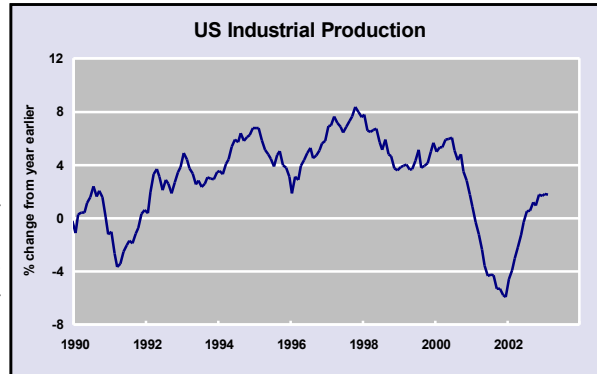


0.2% lower. This signals continued business pessimism and uncertainty about future household incomes. A red flag.

Industrial output rose by 0.1% in February after a more robust 0.8% rise in January. Nonetheless, February production levels were only 1.8% higher than they had been a year earlier after declining in four of the last seven months. In more bad news, the highly regarded survey of supply managers for March foreshadowed a contraction in manufacturing activity. The survey result was the weakest since November 2001.

At face value, this implies a slip toward

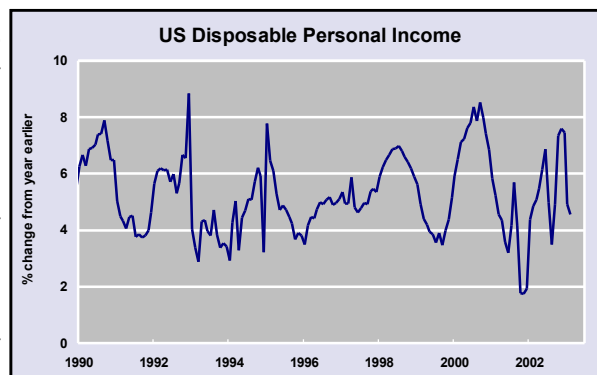
recession. In part, the outcome might have reflected uncertainty associated with the beginning of the war in Iraq. If all goes well in the Middle East, this might turn quickly.



The momentum of manufacturing activity had been showing signs of improvement. The worst of the downturn in activity appears to have occurred a year ago. Production contracted by as much as 5.9% over the year to December 2001.

For this reason, we are inclined to score this a green (albeit slightly faded) flag.

Personal income is a critical building block for consumers as they take their spending decisions. In February, personal disposable income was 4.6% higher than it had been a year earlier. Income growth has been sufficiently robust in the past year to sustain consumption spending at a 4% annual growth rate or better.



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